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Newport, R.I.**

**UNCAGING THE DRAGON:  
Vietnam and the Middle-Income Trap**

**by**

**John P. Smail**

**Lieutenant Colonel, USAF**

**A paper submitted to the Faculty of the Naval War College in partial satisfaction of the requirements of the Department of Joint Military Operations.**

**The contents of this paper reflect my own personal views and are not necessarily endorsed by the Naval War College or the Department of the Navy.**

**Signature: \_\_\_\_\_**

**1 November 2013**



## **CONTENTS**

<b>INTRODUCTION</b>	<b>1</b>
<b>THE CURRENT STRATEGY</b>	<b>2</b>
<b>RELEASING THE COMPETITIVE SPIRIT</b>	<b>5</b>
<b>FREEING PRIVATE ACCESS TO CAPITAL</b>	<b>9</b>
<b>UNLEASHING VIETNAM'S HUMAN CAPITAL</b>	<b>13</b>
<b>CONCLUSION</b>	<b>17</b>
<b>RECOMMENDATIONS</b>	<b>18</b>
<b>BIBLIOGRAPHY</b>	<b>19</b>



## **ABSTRACT**

Vietnam embarked on a path of economic renovation in 1986 that has been remarkably successful. Its economy rapidly expanded from the poorest country in the world in 1993 to a middle-income manufacturer by 2010. Meanwhile, Vietnam has become a significant trading partner of the United States. However, there are signs that not all is well with Vietnam's economy and that the strategy it has employed towards a "socialist-oriented market economy" may be starting to falter. Slowing Gross Domestic Product (GDP), rising inflation, and falling foreign investment point to the possibility that Vietnam is becoming caught in the "middle-income trap." The middle-income trap describes the challenge developing economies face after they rapidly grow into a middle-income economy by providing inexpensive low-skilled labor for manufacturing, but then cannot compete with high-income advanced economies because it lacks the institutions necessary to continue economic growth. The author suggests that strengthening the Vietnamese private enterprise sector is the way to escape the middle-income trap and recommends that Vietnam adjust its current socio-economic strategy to address the core issues that will limit further economic growth. The author recommends eliminating the competitive advantages of Vietnam's large state-owned enterprises, improving private enterprise access to capital, and liberalizing access to the Internet and advanced education in order to develop both the fiscal and human capital necessary to become a high-income economy. Finally, the author concludes with recommendations on how USPACOM may be able to build a closer relationship with Vietnam by assisting its private enterprises.



## INTRODUCTION

The United States needs Vietnam as a strong economic partner in Southeast Asia. The United States exports over \$1 trillion in goods annually to the Asian-Pacific region.<sup>1</sup> Strong economic partners make good security partners and the 2012 U.S. National Security Strategy emphasizes the importance of building relationships with Asian allies and key partners in order to ensure stability and security of the region.<sup>2</sup> Pragmatically, the United States understands that although Vietnam is a one-party communist nation, it can be also be a partner for regional stability. Vietnam's economic transformation has been remarkable and it has become a solid U.S. trading partner during its gradual transition towards free-market capitalism. The Bilateral Trade Agreement with the United States in 2001 and accession into the World Trade Organization in 2007 symbolize Vietnam's acceptance of openness, transparency, and free-market competition in its economy.<sup>3</sup>

Although there is plenty to be confident about in Vietnam, there are signs that not all is well with its economy and that the strategy it has employed towards a "socialist-oriented market economy" may be starting to falter.<sup>4</sup> Slowing Gross Domestic Product (GDP) growth, rising inflation, and falling foreign investment point to the possibility that Vietnam is becoming ensnared in the "middle-income trap."<sup>5</sup> The middle-income trap is a concept first described by Geoffrey Garret as the challenge undeveloped economies face after they rapidly grow from a low Gross National Income (GNI) base into a middle-income economy by providing inexpensive low-skilled labor to manufacture products that were designed in high-

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<sup>1</sup> U.S. Department of Defense, *Sustaining U.S. Global Leadership: Priorities for 21<sup>st</sup> Century Defense* (Washington, DC: GPO, 2012), 2.

<sup>2</sup> Ibid., 2.

<sup>3</sup> World Trade Organization, "Accessions, Viet Nam." accessed October 1, 2013, [http://www.wto.org/english/thewto\\_e/acc\\_e/a1\\_vietnam\\_e.htm](http://www.wto.org/english/thewto_e/acc_e/a1_vietnam_e.htm).

<sup>4</sup> Bill Hayton. *Vietnam: Rising Dragon* (New Haven: Yale University Press, 2011), 3-6.

<sup>5</sup> How We Classify Countries, The World Bank, accessed October 11, 2013, <http://data.worldbank.org/about/country-classifications>.



income economies.<sup>6</sup> Once its wages rise to the middle-income level, Vietnam now faces fierce competition from the low-income economies competing to manufacture the same goods. Also, it cannot compete with high-income economies because it lacks the institutions necessary to develop markets and the high-skilled labor required to participate in an advanced knowledge-based economy. Unless Vietnam modifies its current economic strategy, the factors that limit economic growth will leave it mired in the middle-income trap.

The Communist Party of Vietnam (CPV) understands that the key to its political stability and security is maintaining economic growth. However, its economy is dominated by large inefficient State-Owned Enterprises (SOE) that consume significant state resources but do not produce commensurate growth.<sup>7</sup> Vietnam's current economic strategy preserves the SOE's prominence and attempts to employ the same methods, slightly refined, that were used to attract low-wage manufacturing. The United States should encourage a different approach that increases stability through free-market competition and respect for human rights while achieving Vietnam's goal of increased economic growth. These shared goals can be realized through Vietnam's privately-owned business sector. To unleash private enterprise growth and escape the middle-income trap, Vietnam must adopt a new strategy that eliminates the competitive advantages of the SOEs, improves private access to capital, and liberalizes public access to the Internet and higher education.

### **THE CURRENT STRATEGY**

To understand the current state of Vietnam's economy, it is necessary to discuss some of the past reforms that inform its current strategy. After thirty years of persistent conflict, the Vietnamese centrally-planned economy was in a shambles. Drained of resources, its

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<sup>6</sup> Geoffrey Garrett, "Globalization's Missing Middle," *Foreign Affairs*, November/December 2004, 89.

<sup>7</sup> Also referred to as State-owned Economic Groups (SEG) and General Corporations (GC), both of which are conglomerates of SOEs. SEGs and GCs are referred to as SOEs throughout the paper.

people were disenchanted with the unfulfilled promises of communism.<sup>8</sup> Drastic economic reforms were necessary. In 1986, the CPV embarked on a path of economic renovation called “*Doi Moi*” that has unleashed a remarkable record of economic growth over the last 27 years.

*Doi Moi* initiated Vietnam’s movement towards a market based economy by allowing the formation of small private enterprises, granting 50-year land leases for commercial use, and allowing farmers more freedom to choose what crops to produce and how to operate their farms. It was a spectacular success. Additional reforms were made through the Enterprise Laws of 2001 and 2006 that further reduced barriers to private enterprise creation and were intended to diminish the SOE’s role in the economy through “equitization.”<sup>9</sup> The reforms attracted massive amounts of Foreign Direct Investment (FDI) and resulted in rapid GDP growth. Between 1990 and 2010, Vietnam’s Gross Domestic Product (GDP) growth averaged 7.3 percent<sup>10</sup> and GNI per capita rose from a mere \$170 in 1993--the poorest country in the world--to \$1,400 in 2012.<sup>11</sup> Having become a middle-income economy, Vietnam’s GNI per capita ranked 139 out of the 183 economies measured in 2012.<sup>12</sup>

From 2000-2008, the number of SOEs dropped from 5,759 to 3,692 as both private and foreign firms began to play a much larger role in Vietnam’s economy.<sup>13</sup> While the reduction appears positive, a closer examination shows that many of the SOEs were simply

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<sup>8</sup> Adam Fforde, *Vietnamese State Industry and the Political Economy of Commercial Renaissance: dragon's tooth or curate's egg?* (Oxford: Chandos Publishing Limited, 2007), xv.

<sup>9</sup> The World Bank, *Vietnam Development Report 2012: Market Economy for a Middle Income Vietnam*, December 6, 2011, 26. Equitization is the process Vietnam uses to “privatize” the SOEs by selling shares on its stock market. Private is a relative term since the state often retains 51 percent controlling equity.

<sup>10</sup> *Ibid.*, 26.

<sup>11</sup> Vietnam, The World Bank, accessed October 12, 2013, <http://data.worldbank.org/country/vietnam>.

<sup>12</sup> World Development Indicators: Size of the economy, accessed October 31, 2013, <http://wdi.worldbank.org/table/1.1#>.

<sup>13</sup> The World Bank, *Vietnam Development Report 2012*, 26.

rolled up into larger state enterprise groups or general corporations to reduce the overall number of SOEs, but not significantly reducing the state's participation in the market.<sup>14</sup> The trend in SOE reductions actually reversed in 2009 and now almost 4,000 SOEs operate in Vietnam.<sup>15</sup> Even though SOEs struggle to keep pace with the performance of private and foreign firms, they still represent 122 of the country's top 200 largest firms.<sup>16</sup> In contrast, of the over 100,000 private firms, only 22 are on the top 200 list.<sup>17</sup>

The CPV understands the economy now faces significant challenges. Highly reliant on export manufacturing, the Vietnamese economy has been hit especially hard since the 2008 financial crisis and the resultant global economic downturn. Recent economic indicators signal that the rapid growth experienced over the last two decades may be at an end. High inflation, falling FDI, and slowing GDP growth result in an economy that is actually going backwards.<sup>18</sup> The CPV's *Vietnam's Socio-Economic Strategy for the Period of 2011-2020* acknowledges that reforms are necessary to achieve their goal of doubling Vietnam's GNI to \$3,000 by 2020.<sup>19</sup> However, the strategy is highly abstract with little discussion of meaningful SOE reform. It expresses the need for private enterprise to take a more active role in future growth, but lacks specifics that demonstrate substantial government support for the private sector.<sup>20</sup> The key to escaping the middle-income trap lies

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<sup>14</sup> Ibid, 27.

<sup>15</sup> Scott Chesier and Penrose Jago, *Top 200: Industrial Strategies of Viet Nam's Largest Firms*, (UNDP, 2007), 6.

<sup>16</sup> Chesier and Jago, *Top 200*, 6.

<sup>17</sup> Ibid, 6.

<sup>18</sup> The World Bank, *Taking Stock: An Update on Vietnam's Recent Economic Developments*, (Hanoi, July 10, 2013), 16-19. In 2012, Real GDP fell to 5.3%, the lowest rate in 14 years. Inflation averaged 16% from 2008-2011 and FDI fell from 12% of GDP in 2007 to 7% of GDP in 2012.

<sup>19</sup> Communist Party of Vietnam, "Vietnam's Socio-Economic Strategy for the period of 2011-2020," accessed October 15, 2013, <http://www.economica.vn/Portals/0/MauBieu/1d3f7ee0400e42152bdcaa439bf62686.pdf>.

<sup>20</sup> Communist Party of Vietnam, "Vietnam's Socio-Economic Strategy for the period of 2011-2020."

with Vietnam's Small-to-Medium Enterprise (SME) private sector.<sup>21</sup> If true free-market competition is enabled, the agility of private enterprises will result in more rapid innovation, efficiency, and the increased productivity necessary for an advanced high-income economy.

### **RELEASING THE COMPETITIVE SPIRIT**

Competition is the central feature of a free-market economy that makes capitalism the world's most successful economic system. However, competition is stifled in Vietnam because the large SOEs have circumvented central government reforms in order to obstruct direct and fair competition with private enterprise.<sup>22</sup> The large SOEs dominate the economy and the business elites with local party connections run them like privileged semi-private corporations.<sup>23</sup> The Enterprise Laws were intended to equitize the SOEs and encourage competition with private enterprise. While initially very successful at attracting massive FDI, foreign investors now see equitization simply as a method for SOEs to raise money rather than to raise capital for new, more productive initiatives. Furthermore, since the state has retained a 51 percent controlling share of SOEs, several critical industries are still protected from private competition.<sup>24</sup> In fact, Vietnam's economic competitiveness has fallen 16 places in two years in the *Global Competitiveness Index* and now is ranked 75 out of the 144 world economies and 7 out of the 8 ASEAN countries.<sup>25</sup> The drop in competitiveness is largely attributed to a lack of transparency, corruption, and inefficiency by public institutions in general, and SOEs in particular.<sup>26</sup> For Vietnam to escape the middle-income trap, structural changes must be made to increase free-market competition and reduce

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<sup>21</sup> SMEs are defined here as private enterprises of 300 or less employees.

<sup>22</sup> Fforde, *Vietnamese State Industry and the Political Economy of Commercial Renaissance*, 221-223.

<sup>23</sup> Ibid., 214.

<sup>24</sup> The World Bank, *Vietnam Development Report 2012*, 28. Industries include coal, electricity, and telecom.

<sup>25</sup> Klaus Schwab, *The Global Competitiveness Report 2012-2013*, (Geneva: World Economic Forum, 2012), 30.

<sup>26</sup> Schwab, *The Global Competitiveness Report 2012-2013*, 30.

the SOE's dominant role in the economy. Specifically, Vietnam must reduce SOE market advantages, fully privatize non-strategic industries, and encourage foreign investment in domestic private enterprises.

Real or perceived government favoritism is a major obstacle in the willingness of SMEs to cooperate, initiate joint ventures, or compete for government business. As the chief executive of publisher Le Media Joint-Stock Co., Le Quoc Vinh stated, "if you're not friends with that state-owned company, it's difficult to win a contract."<sup>27</sup> Worse, the SMEs are inclined to stay out of the government's spotlight so they are not considered a threat to the SOE's interests and draw the attention of regulators. Meanwhile, SOEs enjoy significant advantages in their ability to skirt regulatory compliance. As Martin Gainsborough points out in his study of Vietnam's political economy, "in Ho Chi Minh City, there is scarcely a city department or a district that does not have companies under its jurisdiction."<sup>28</sup> Local party officials exercise significant leeway in how they interpret central party decrees. In order to protect the SOEs, these local government-SOE partnerships can result in inspectors purposely interpreting regulations to the SME's disadvantage in exchange for rents. When asked in an International Finance Corporation study if they agreed that "government agencies use regulations as a tool for rent extraction," two-thirds of the private enterprise respondents agreed and the average SME bribe rate reported was 3.1 percent of sales revenues, a rate double that of the SOE respondents.<sup>29</sup> The current competitive climate places SMEs in a curious growth dilemma. The key is to be profitable, but not too profitable; to grow, but

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<sup>27</sup> *Bloomberg News*, "Vietnam Economic Rise Threatened as Middle-Income Trap Looms," October 17, 2012, <http://www.bloomberg.com/news/2012-10-16/vietnam-economic-ascent-threatened-as-middle-income-trap-looms.html>.

<sup>28</sup> Gainsborough, *Changing Political Economy of Vietnam*, 19.

<sup>29</sup> Stoyan Tenev et al, *Informality and the Playing Field in Vietnam's Business Sector* (Washington D.C.: IFC, 2003), 35.

don't grow so large as to attract the state's attention. Obviously, this is not the foundation necessary for an economy to escape the middle-income trap.

Competition in Vietnam is additionally hampered by the SOEs blocking private participation in “strategic” industries.<sup>30</sup> Many industries, “including: military, monopoly industries, provision of primary goods and services, and high technology sectors,” are legally restricted to only SOE participation.<sup>31</sup> Some of the protected industries may plausibly be considered strategic to a communist government. Other industries, such as jewelry, tourism, and beer breweries are not legally protected, yet still have a large government presence and it is difficult to explain why there is any SOE involvement. The CPV may reasonably argue that they have already privatized enough industries and want to retain what is still in state control. In fact, the state retaining ownership in a few strategic industries may be warranted to ensure short-term economic stability.<sup>32</sup> Nevertheless, Vietnam must significantly reduce what is defined as strategic and completely privatized those industries that are not. True industry privatization will subject all enterprises to the same competitive rules, increase productivity, and open new markets and opportunities to the SMEs.

The SMEs additionally face tough competition from the large number of foreign-SOE partnerships operating in the manufacturing sector. Foreign firms invested with the SOEs early during *Doi Moi* to gain access to input factors such as land and labor. The CPV placed strict limits on the type and amount of foreign-private enterprise partnerships.<sup>33</sup> Since only state-owned enterprises could conduct foreign trade until 1998, they attracted most of the FDI contracts well into the 2000s which gave them a substantial head-start in manufacturing

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<sup>30</sup> The World Bank, *Taking Stock: An Update on Vietnam's Recent Economic Developments* (Hanoi: The World Bank, 2013), 39.

<sup>31</sup> *Ibid.*, 39.

<sup>32</sup> The World Bank, *Vietnam Development Report 2012*, 35.

<sup>33</sup> Gainsborough, *Changing Political Economy of Vietnam*, 30.

market share.<sup>34</sup> Because of this advantage, 17 major industries, including: appliances, furniture, engines, and bicycles are now entirely operated by foreign manufacturing firms with no private participation.<sup>35</sup> The significant benefits of access to input factors, early entry, and monopoly markets make it very difficult for the SMEs to now gain a foothold and be able to move up the business value chain and increase productivity.

To escape the middle-income trap, Vietnam must begin to improve the competitive landscape for private enterprises. Although there has been equitization of the SOEs, it requires full privatization, true competition, and transparency to eliminate real and perceived market advantages and rent seeking. Vietnam should fully privatize all but the most “strategic” of industries. Although difficult, it will require the elimination of close government and SOE connections, at both the provincial and central levels of the CPV. After reducing state involvement, Vietnam must encourage foreign-private partnerships in non-strategic areas that can be an incremental step that will allow SMEs to take advantage of foreign expertise and growth opportunities that are currently closed to them. For example, to strengthen the partnership with Vietnam and assist the growing SMEs, the United States, through USPACOM, could request to contract with specific private firms based on unique products or services the firms could provide U.S. forces in the area. This would provide a small firm a large customer on which to gain experience and expand its business. In combination, these initial steps will begin to reduce the competitive advantages of the SOEs and improve the SME’s opportunity to contribute to Vietnam’s development into a high-income economy. However, growth requires access to input factors such as business loans and land to expand operations and take advantage of these new markets.

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<sup>34</sup> Gainsborough, *Changing Political Economy of Vietnam*, 30.

<sup>35</sup> Chesier and Jago, *Top 200*, 7.

## **FREEING PRIVATE ACCESS TO CAPITAL**

In order for private enterprise to take advantage of free market competition, it must be able to raise capital in order to conduct research and development, modernize facilities, invest in new equipment, and expand operations. On the surface, the Enterprise Laws of 2001 and 2006 appeared to have encouraged more private access to credit. In practice, the SMEs face several formal and informal obstacles to raising capital. With limited access to input factors such as loans and land, small and medium private firms cannot expand and Vietnam's macroeconomic productivity growth is artificially stifled. Since private enterprises routinely outperform state-owned enterprises in free-market economies, it is imperative that Vietnam's State Owned Commercial Banks (SOCB) increase the percentage of lending that goes to private enterprises in order to increase economic growth. Specifically, Vietnam must reduce SOE borrowing, encourage the SOCBs to lend to private enterprises, and modify existing regulations that limit the SME's ability to obtain land-use rights.

The primary lending sources in Vietnam are the SOCBs. There is a close relationship between the banks and the SOEs that results in capital being misallocated from the private sector to the state enterprises. Harvard economist Larry Pincus points out that "SOEs account for 60 percent of the outstanding loans of the SOCBs and 70 percent of Vietnam's foreign borrowing while producing only 40 percent of the country's GDP."<sup>36</sup> One reason for this is that the local CPV provincial directors are incentivized by the central committee to improve local infrastructure. In order to make progress in their province, local government representatives push SOCBs to routinely divert capital away from private enterprise into state projects that are of limited public good, such as overbuilding sea ports and creating

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<sup>36</sup> Jonathon Pincus, "Interview with the Dean, Fullbright Program," accessed October 12, 2013, <http://www.itv-asia.com/interview/Jonathan-Pincus>.



underutilized industrial parks.<sup>37</sup> This results in a distorted market where SMEs are discriminated from lending and the SOEs are encouraged to borrow for projects that have little possibility of providing a return on investment.<sup>38</sup> Some of the SOE lending is not intended for the public good, but private gain. The central bank chief, Nguyen Van Binh admits that SOCBs are under pressure to lend to SOEs and, in the extreme, have resulted in some lenders making up to 90 percent of loans to a single enterprise.<sup>39</sup> The collapse of Vinashin, the country's largest shipbuilding SOE is a prime example of how SOE and SOCB collusion can go very wrong.<sup>40</sup> The true harm to growth is in lost private opportunities. Since SOEs will most likely remain a large part of the economy, Vietnam must restrict the SOE's borrowing to activities in its primary area of business in order to free limited capital for the SMEs to invest.

To direct capital away from the SOEs and into the private sector, Vietnam must modify existing laws that cause the SOCBs to discriminate against the SMEs. For example, in Vietnam it is a capital offense to lose public funds.<sup>41</sup> The directors of the SOCBs fear that if they loan to the SMEs they will be held criminally responsible for any losses. In order to protect themselves, the SOCB directors prefer to lend to SOEs and spread the responsibility between two state entities should the SOE default. This sort of relationship between the lender and the state is highly inefficient in a market-based economy and skews the analysis of true default risk. Vietnam must remove the criminal punishment for loan losses unless there is flagrant wrongdoing. The SOCBs should only be accountable for applying due

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<sup>37</sup> The World Bank, *Vietnam Development Report 2012*, 57-59.

<sup>38</sup> Suiwah Leung, The Far East and Australasia, Viet Nam: Economy, Europa World Plus, accessed September 25, 2013, <http://www.europaworld.com.usnwc.idm.oclc.org/entry/vn.ec>.

<sup>39</sup> *Bloomberg News*, "Vietnam Economic Rise Threatened as Middle-Income Trap Looms."

<sup>40</sup> The Ministry of Finance, "Restructuring plan for debt-grappled Vinashin okayed," November 22, 2010, [http://www.mof.gov.vn/portal/page/portal/mof\\_en/rd?pers\\_id=2420095&item\\_id=25260008&p\\_details=1](http://www.mof.gov.vn/portal/page/portal/mof_en/rd?pers_id=2420095&item_id=25260008&p_details=1).

<sup>41</sup> Leung, The Far East and Australasia, Viet Nam: Economy, Europa World Plus.

diligence and ensuring the borrower is following generally accepted accounting practices, not to have zero loan defaults. To increase oversight and reduce risk, Vietnam could encourage the large SOCBs to lend to the smaller private local banks that can then lend directly to SMEs. Local banks typically are more familiar with small businesses in its area and can more accurately verify its tangible and intangible assets. Increased visibility and an accurate assessment of both income and assets will improve access to capital for the SMEs and reduce defaults. Once the regulatory changes are made to free available capital for private lending, Vietnam must reduce the obstacles private enterprises face in obtaining government certificates of land-use rights.

As capital is reallocated from the SOEs to the private sector, the SMEs must be able to qualify for this new credit source. Seventy percent of SMEs believe that a lack of collateral is a significant impediment to obtaining credit with the banks.<sup>42</sup> Currently, it is difficult for private enterprise to raise capital from the SOCBs because many SMEs lack a certificate of land-use rights to offer as collateral. It is a significant barrier to private sector growth. For example, 82 percent of private CEOs stated in a survey that they would expand plant operations if they could obtain more land.<sup>43</sup> All of the land in Vietnam is formally owned by the central government. In order to use the land for commercial purposes, an enterprise must obtain a certificate of land-use rights from the local government. The SOEs were able to obtain land-use rights early in the reform process and now control most of the commercial land in Vietnam. Since the SOEs have control of most of the land, it is easier for the SOCBs to qualify the SOEs based on its current assets.<sup>44</sup> The CPV's 1999 "Decree 178"

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<sup>42</sup> Tenev et al, *Informality and the Playing Field in Vietnam's Business Sector*, 64.

<sup>43</sup> Ibid., 89.

<sup>44</sup> Leung, *The Far East and Australasia, Viet Nam: Economy, Europa World Plus*.

was intended to address this inequity by allowing banks to lend to SMEs without collateral.<sup>45</sup> However, there is still a bias towards SOE lending and requiring private enterprises to have approved land-use rights as collateral. SMEs that do attempt to transition land from personal use or obtain additional land must gain permission from the local government. This can be a long process where SMEs face significant obstacles. For example, “private enterprises reported that the average processing time for them was about 200 days, compared with only 2 days for SOEs.”<sup>46</sup> Land is not the only asset that can be used as collateral, however it the easiest to value and safest for the banks to use without fear of loss. Improving private access to land-use rights is technically easy to do, however there are significant political impediments to actually changing the environment. It is imperative that the central government support the SMEs ability to access land so to expand business operations and increase economic growth.

In summary, improving the ability to raise capital through normal markets is essential to increasing Vietnam’s private sector growth. To escape the middle-income trap, the SOEs must reduce borrowing to only projects in its core line of business. Next, legal and regulatory impediments that impede SOCB lending to Vietnam’s SMEs should be removed and normal accounting standards must be applied to both the private and public sectors. Finally, it is essential to assist the SMEs qualify for credit by eliminating barriers in obtaining commercial land-use rights. Additionally, the United States could improve the U.S-Vietnam security partnership by encouraging U.S. banks to provide preferential lending to private SMEs in order to offer USPACOM contract services in the area. Once Vietnam’s SMEs are competing on a level playing field and have access to new capital to expand, they

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<sup>45</sup> Tenev et al, *Informality and the Playing Field in Vietnam’s Business Sector*, 65.

<sup>46</sup> Ibid., 67.

will need a highly educated workforce and global Internet connectivity to lead Vietnam into a knowledge-based high-income economy.

### UNLEASHING VIETNAM'S HUMAN CAPITAL

The rapid growth of Vietnam's economy resulted from the CPV pragmatically compromising their communist principles and incrementally implementing capitalist market-based reforms in order to maintain one-party control. Before China, the conventional belief was that this was a fool's errand that could only end in one of two ways: a sharp reversal of the economic reforms or the eventual fall of the one-party system in favor of a multi-party democracy. Bruce Bueno de Mesquita and George Downs argued in *Foreign Affairs* that the transition to a free-market economy alone is not enough for democracy to flourish.<sup>47</sup> Rather, a one-party government can restrain the call for democracy through the control of "coordination goods."<sup>48</sup> They defined coordination goods as basic human rights that democracies typically enjoy, including the freedom to participate in the political process, freedom of religion, media, and wide access to advanced education.<sup>49</sup> The CPV is attempting to balance free-market economic reforms to achieve economic growth, but limit the institutions and capabilities that could stimulate new political philosophies and organize opposition to the one-party system.<sup>50</sup> While there is merit in the argument that the CPV can obstruct a challenge to the one-party system through the control of coordination goods, it does so at the cost of finding itself caught in the middle-income trap in perpetuity. If Vietnam is to transition into the high-income level of world economies, it must take a liberal

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<sup>47</sup> Bruce Bueno de Mesquita and George W. Downs. "Development and Democracy," *Foreign Affairs*, September/October 2005, 82.

<sup>48</sup> Ibid. Freedom of the Internet is included as a basic human right in accordance with the U.S. State Department and Freedom Online Coalition statement.

<sup>49</sup> Ibid.

<sup>50</sup> Ibid., 85.

approach to freedom of information, specifically the Internet, and ensure all its citizens have access to high-quality advanced education.

The 21<sup>st</sup> century economy is characterized by globalization, information, and knowledge-based skillsets and the CPV's economic strategy is clear in its desire to promote science, research and development.<sup>51</sup> However, Vietnam has taken a decidedly aggressive approach to controlling information. Recently, Prime Minister Nguyen Tan Dung signed "Decree 72" that aggressively restricts Internet access. According to the U.S. Department of State and The Freedom Online Coalition, Vietnam's new "Decree 72" will violate human rights by imposing "further restrictions on the way the Internet is accessed and used in Vietnam" and "limits the sharing of certain types of news and other speech."<sup>52</sup> In defense of the new law, the Deputy Minister of Information and Communications, Le Nam Thang only heightened the concern by saying "the new decree is intended to prevent the spread of false information online...and will help users 'find correct and clean information on the Internet'."<sup>53</sup> This severe tightening of Internet controls indicates serious CPV insecurity and is a significant step backward on the path to a high-income country. SME's rely heavily on open access to information and communications in order to advertise, innovate, and coordinate with suppliers and new customers. Restricting access to only "correct and clean" information will have a deleterious effect on promoting research and development and increasing productivity.

To escape the middle-income trap, open access to the Internet combined with a highly-educated workforce must be a central tenant of Vietnam's economic strategy.

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<sup>51</sup> Communist Party of Vietnam, "Vietnam's Socio-Economic Strategy for the period of 2011-2020," 19.

<sup>52</sup> U.S. Department of State, *Freedom Online Coalition Joint Statement on the Socialist Republic of Vietnam's Decree 72*, August 26, 2013, <http://www.state.gov/r/pa/prs/ps/2013/08/213505.htm>.

<sup>53</sup> Mong Palatino, "Decree 72: Vietnam's Confusing Internet Law," *The Diplomat*, August 8, 2013, <http://thediplomat.com/asean-beat/2013/08/08/decree-72-vietnams-confusing-Internet-law/>.

Advanced education differs markedly from basic education in the way that it encourages the student to think and develop arguments and new ideas—skills that are crucial in today’s complex, rapidly evolving, knowledge-based economy. Science, information technology, medicine, and engineering rely heavily on the ability to coordinate with peers, propose new ideas, and share research. Without these skills, and the networks to utilize them, an economy is at a distinct disadvantage and is relegated to taking innovations and technologies from the knowledge-based economies and simply replicating them at cheaper prices.

Vietnam has been an attractive location for foreign manufacturers because of its large amount of inexpensive labor with a basic education. Indeed, with a 93 percent literacy rate, Vietnam’s basic education is above average and is ideal for firms looking to manufacture products designed elsewhere.<sup>54</sup> Vietnam’s rapid rise from the low-income to middle-income, as described earlier, is highly attributable to this fact. To rise into the high-income category however, Vietnam must improve its university system and allow more of its citizens the opportunity for an advanced education, including masters and doctorate programs. While Vietnam’s basic education is good, it has a long way to go when it comes to advanced levels of education. Vietnam currently doesn’t have one university that makes the list of the world’s top 500 universities.<sup>55</sup> Its current university system is dominated by Marxist-Leninist ideas and requires military training to graduate.<sup>56</sup> To highlight this shortfall from a recent case, Intel built its largest and most sophisticated chip test facility in its global network in Vietnam; however, it has “yet to have enough personnel for its project, and Vietnam still falls short of institutions that can develop world-class IT engineers, programmers and

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<sup>54</sup> Literacy rate, adult total (% of people ages 15 and above), The World Bank, accessed October 31, 2013, <http://data.worldbank.org/country/vietnam>.

<sup>55</sup> International Bank for Reconstruction and Development, *China 2030: Building a Modern, Harmonious, and Creative Society* (Washington, D.C.: The World Bank, 2013), 37.

<sup>56</sup> Hayton, *Vietnam*, 13.

software workers.”<sup>57</sup> Illustrative of how important advanced education is to economic success, every country, except one, with over five universities on the top 500 university list are high-income economies. The only middle-income country on the list is China, and they are a high middle-income economy with a population over one billion.

One could argue that China has been able to successfully employ this control of coordination goods strategy since the 1970s with limited political resistance while enjoying outstanding economic growth. While true, they are still in the middle-income trap. To escape, China will eventually have to release the creativity of its population, and when they do it is doubtful the Chinese people will stay satisfied with limited political freedom.

The control of coordination goods will eventually fail. The CPV has been able to maintain political control while the population was content with rapidly rising incomes, however, the real test is yet to come. Will the Vietnamese be content to be “stuck in the middle” while their government continues to promise growth it can no longer deliver? As Geoffrey Garrett first described, middle-income countries must “tech up in order to join the global knowledge economy, so as to escape the trap of having to dumb down to compete in standardized manufacturing.”<sup>58</sup> Without Internet freedom and advanced education for all, Vietnam will remain a middle-income economy. The United States must continue to encourage open access to the Internet and offer opportunities for the Vietnamese to attend U.S. research universities. Additionally, opportunities exist to develop enduring relationships through the U.S. military academies and the service’s war colleges to further strengthen the partnership.

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<sup>57</sup> Le Dinh Tinh, "Can Vietnam be another start-up nation?" *East Asia Forum*. July 6, 2013, <http://www.eastasiaforum.org/2013/07/06/can-vietnam-be-another-start-up-nation/>.

<sup>58</sup> Garrett, "Globalization's Missing Middle," 89.

## **CONCLUSION**

A close economic relationship with Vietnam is a key pillar of the U.S. theater strategic engagement plan in Southeast Asia. A vibrant and robust private economy in Vietnam will incentivize the CPV to continue close cooperation with trading partners and help ensure free trade and peace in the region. To be a strong economic partner, Vietnam must change its current socio-economic strategy and escape the middle-income trap. Vietnam has capably managed the transition from a completely closed centrally-planned economy to socialist-oriented market economy. However, the leap from a middle-income to high-income economy is much more difficult to accomplish.

The CPV must drastically improve the competitive conditions that face Vietnam's SME private sector. First, they must eliminate the close SOE-local party connections and minimize the artificial advantages enjoyed by the state enterprises. Also, SOE involvement in industries that clearly could be privatized must end so to free these markets for private enterprise. Additionally, SMEs should be helped to enter industries that are currently monopolized by foreign firms. These reforms must be initiated from the top and enforced at the local level to prevent local regulators from extracting rents and the SOEs from attempting to block private enterprise participation in the market.

Next, fair competition must be combined with increased private enterprise access to capital. Eliminating laws that criminally punish bank officials for defaults and discouraging SOE lending outside its core business must happen quickly. Combined with improving private enterprise's access certificates of land-use rights for commercial purposes will open new opportunities for the SMEs and will drive the innovation and expansion necessary to increase economic productivity.



Finally, the CPV must resist the instinct to protect their power by restricting coordination goods, especially Internet access and advanced education. A high-income economy needs access to information and highly-educated people to develop the products and services necessary to compete in a globalized economy. The combination of free-market competition, efficient use of limited capital, and unleashing the Vietnamese people's creative spirit will provide more economic growth than any centrally-planned economic strategy could ever realize.

### **RECOMMENDATIONS**

- USPACOM could foster free-market competition by seeking private SMEs to offer small contracts for services on the basis of truly unique or best value
- The United States should encourage U.S. banks to provide capital to private SMEs that need assistance to expand in order to offer USPACOM the contract services it needs in the area
- In coordination with the U.S. Department of State, encourage open access to the Internet and offer opportunities for Vietnamese students to attend U.S. research universities, U.S. military academies, and the services war colleges

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